RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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June 14, 2000 **LETTER 1302**

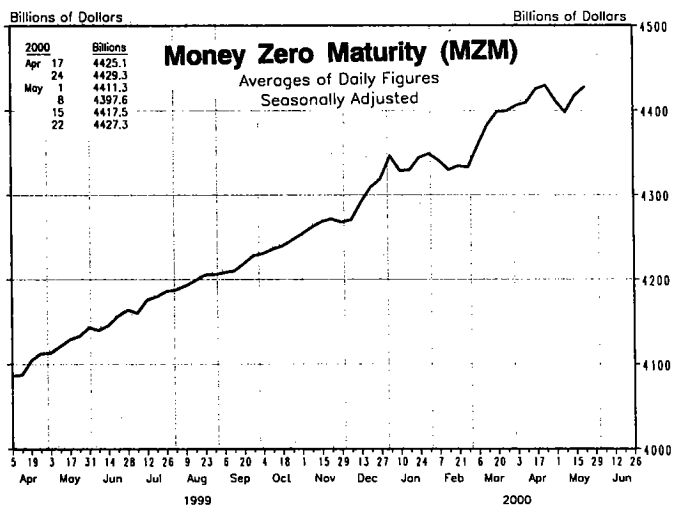
May 26, DJIA 10299.24; PTI 5109; A-D Ratio -7.87
June 2, DJIA 10794.96; PTI 5123; A-D Ratio -6.68
June 9, DJIA 10614.93; PTI 5125 ; A-D Ratio - 6.55
Dow Yield: 1.58%; Dow Price/Earnings: 20.7
Dow Times Book Value: 6.27%
Percentage of Undervalued Blue-chips: 14%
Gold 34-day MA: 280

THE PICTURE: I hesitate to tell you this, but this bear market looks to be long, tortuous, and extended. Consider this -- the first phase of the bear market has already lasted more than a year, and we're still not through with the first phase.

So saying, this might be a good time to review the three phases of a bear market. Remember, the phases are **psychological** phases and do not deal with the price action.

The first psychological phase is the phase in which the market erases the foam and froth of the previous bull market's top. We're in the first phase now; we've been in this phase for over 13 months, and the first psychological phase still shows few signs of ending.

One reason why the first phase has lasted so long is that the **Fed has been fighting the bear with money.** When I say money, I mean money supply. Right now, despite boosting interest rates, the Fed is allowing the Adjusted Monetary Base to rise while MZM (comparable to cash) is rising in at least an 8% annualized rate (see chart). Evidently, Greenspan thinks by boosting rates but at the same time making money very available, he can put a ceiling on the upside and a floor on the downside, the result, hopefully, a soft landing.


Billions of Dollars
Billions of Dollars
2000 Billions
Apr 17 4425.1
24 4429.3
May 1 4411.3
8 4397.6
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22 4427.3
Money Zero Maturity (MZM)
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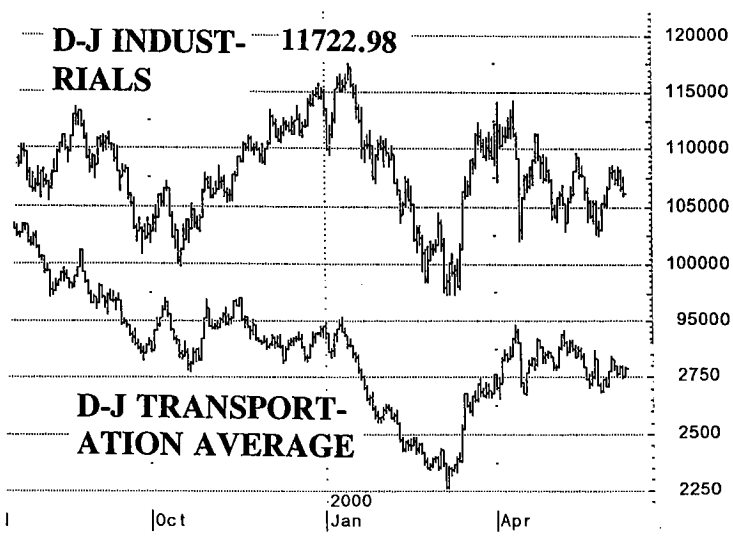
Apr May Jun Jul Aug Sep Oct Nov Dec Jan Feb Mar Apr May Jun
1999
2000

The second psychological phase of a bear market sees stocks decline as they discount obviously deteriorating conditions in business and in corporate earnings. In the early part of the second phase, investors start to pull back on their enthusiasm for stocks. But as the second phase progresses, investors turn increasingly bearish, with many individual stocks and groups suddenly collapsing. The second phase is generally the longest phase of a bear market.

The third phase of a bear market is characterized by black pessimism on the part of investors. Here the bad news comes out in a never-ending stream, and stocks plunge accordingly. In the third phase, those who have saved for a rainy day wake up to find that it's raining. In the third phase investors dump whatever stocks they still hold for whatever the market will bring, and the blue chips (the last to decline) go down with the rest. In this final phase, you will hear expressions such as "This is the end of the stock market as we know it," and "If you ever mention stocks again, I just might shoot you." By the time the third phase ends, the Dow might well yield 6% or even more, while the price/earnings ratio for the Dow might be down to 10 or even lower.

Remember, the three phases are psychological, based on stockholders' sentiment. Occasionally, but not always, the phases may be separated by price action. In the current instance, I believe that if or when the Dow breaks below its bear market low of **9796.03** the first phase will have ended and the second phase will have begun.

Interview with your editor in this week's Barron's.



I've been talking about the Fed's quandary on my Internet site, but I want to go over this thesis again for those who are not yet on the site. Today stocks are so widely held by so many people that to all intents and purposes, the stock market IS the economy.

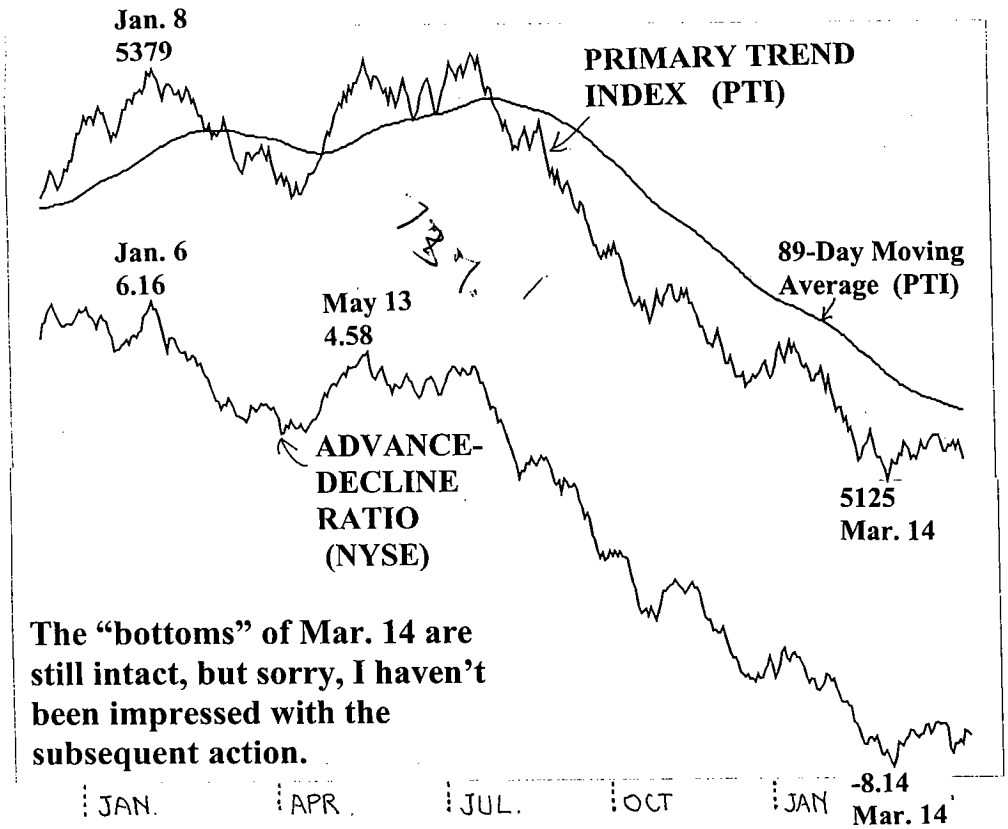
If Greenspan wants to put a brake on currently accelerating inflation, he will have to slow the economy down. But since the stock market IS the economy, that, in turn means he must halt the stock market's upward momentum. However, there are a number of problems connected with slowing the market or let's say "putting a ceiling on the market."

First, changes in interest rates can take a year to show up in the economy. Meaning that what the Fed does now may not show up for let's say six to 12 months. If the Fed raises rates again on June 28 (their next meeting) they may be going too far, but they won't know that until the end of this year or maybe not until 2001. By that time, the Fed may have thrown the nation into recession.

On the other hand, if the Fed stands pat on June 28 the stock market may well take it that the Fed is finished raising rates until at least after the November election. In that case, the stock market could feel free to surge higher, knowing that the Fed will not interfere. Of course, the last thing Greenspan wants now is a surging stock market that is testing its high again. Greenspan also knows that a climbing stock market will generate even more bullishness among consumers, and inflation (which is now accelerating) will increase even more rapidly.

In the face of all the above, what will Greenspan do? The Russell guess: bullishness is still rampant in both the stock market and in the minds of the public.

and in the economy. Regardless of any phoney government statistics that are released, Greenspan knows that inflation is accelerating. I'm guessing that he'll boost rates again -- by .25 basis points. Greenspan wants to get any further rate boosts out of the way well before the election. He'll move on June 28.



Money supply: Back in the 80s, the money supply was a big topic for Wall Street. Now interest rates have taken the place of the money supply. From what I read and hear, MZM (money of zero maturity, equal to cash) is what the Fed watches most closely. The chart on page 1, courtesy of the St. Louis Fed, shows the rate of change for MXM. The rate of change is in a declining trend. This is a negative force on both the stock market and the economy. If this trend of declining growth in MZM continues, and I think it will, it will exert a negative force on both the stock market and the economy.

Conclusion: I think what we saw during March and April was a rally in a bear market. I think the Fed's manipulations are serving to extend the first phase of this bear market. I think that slowly but surely the public is going to be discouraged with the market, mainly because it's becoming so hard to make money in this market.

The chart on page 2 shows four consecutive Dow rallies with each peak below the previous. The declining peaks imply a weakening Dow. **Yet the lows in the 10300 area have held.**

This can't go on indefinitely. In due time the Dow will either break above 11287 and keep rising to test the January high -- or the Dow will decline to test its low at 10300. If the Dow breaks below 10300 it will be in line to test its bear market low at 9796.03.

Aside from the above, I'm watching the **10759 level,** this is the 50% or halfway level of the January to March decline. If the Dow can hold stubbornly ABOVE 10759 it will be a bullish indication. Conversely, if the Dow holds persistently below 10759 it will be a bearish indication. As this is written, the Dow appears to be having trouble in deciding which side of 10759 it wants to be. Here again, the Dow can't waffle forever -- it will have to make up its mind. When it does, that will be significant.

INVESTMENT POSITION: It occurs to me that if I use the expression "investment position," it's an oxymoron, in that most of what we see out there are not investments, they are rank speculations predicated on rising prices.

True investments offer a return on the investment, and in today's markets, for the most part, as far as stocks are concerned, there are no returns. There's only the hope of higher prices. This isn't investing. It's a speculation that what you buy will go up in price -- in which case, you'll be able to sell your wares to a "greater fool."

In my experience, that involves a process that I call "hoping," hoping for higher prices. Personally, I'm not in the hoping business. Anytime in this business I find that I'm hoping, I want "out." I don't want to be in a position of hoping.

Which is why I believe that the proper investment vehicle at this time is interest-bearing securities. You pick 'em: T-bills, T-notes, T-bonds, AA-rated muni bonds, AAA corporate bonds. All of these pay attractive rates of interest. All of them appear to me to be bargains compared with the average run of stocks -- where if you buy 'em, you're hoping that they go up.

Eighteen years of generally higher prices has destroyed the concept of risk. Eighteen years of generally higher prices has erased from investors' minds the value of dividends or interest -- the return on your investment.

The bear, in due time, will refresh investors' memories regarding the return on investment. In due time, the concept of values will be imprinted again on the minds of today's investors.

My final thought in this section is that studies show that when price/earnings ratios are **22** or higher (the P/E on the S&P is now **29**), the median return over the following ten years was 5.0%. I can do better than that with tax-free bonds.

NOTES & QUOTES -- The following appeared on my web site on May 24, but for those who do not tune in to my site, this is a piece that I didn't want you to miss.

Very important: I note that some of the advisory services, even some of the very good ones, are looking at the Technicals and concluding that the market is readying itself for a good rally. I want to warn them (many of them read these daily reports) that the Technicals do NOT work in a bear market the way they work in a bull market.

Remember, in a bear market the bears are right, just as in a bull market the bulls are right. Here's an example of what I'm talking about: in a bull market a build-up in the short position is very bullish since in a bull market the shorts are positioning themselves **against the primary trend** and are therefore **wrong.**

But in a bear market a build-up in shorts is NOT bullish since in this case the shorts are positioned correctly in harmony with the bearish primary trend. Therefore, those who believe that the high short position in the current bear market is a bullish factor do not understand the picture. A high short position in a bear market is not a bullish factor.

* * *

I think the entire mutual fund business is now very vulnerable. Vulnerable to what? To the "new" exchange-traded funds or ETFs. These are easily traded securities that track market indexes or industry sectors. They have the advantage of being traded all day long vs. mutual funds which can only be bought or sold after the session closes. Furthermore, ETFs aren't subject to the same taxes as mutual funds. For instance, if a mutual fund takes a lot of profits in stocks and later the fund declines, the holder may be subject to taxes on the profits taken, but at the same time he may find his fund down substantially. In other words, he may take a double beating, first on taxes and second on the price of the fund. Finally, the management fees on the ETFs are generally much lower than the fees on most mutual funds.

Most of the ETFs are traded on the AMEX. The first ETF was the Spyder (SPY) indexed to the S&P. Now there is DIA indexed to the Dow; QQQ indexed to the Nasdaq 100; IWM indexed to the Russell 2000; HHH Internet; BBH biotech; TTH Telecom; IYV Dow Jones Internet; IDU Dow Jones Utilities; IYR Dow Jones real estate; IYE Dow Jones energy, IYG Dow Jones financial services. And on and on. Barclay is coming out with a whole series. Vanguard is going to offer ETFs.

So as the public becomes educated in ETFs (which they will), watch for a steady exit from mutual funds, most of which offer minuscule dividends (why hold them if you can hold ETFs instead?).

* * *

I go into Vons supermarket, and I look at a box of Post's GrapeNuts. Four bucks a box. Then I look at Vons' own copy of GrapeNuts -- price 2.75. The hell with Post's GrapeNuts, I'll buy the Vons brand which is identical, and I mean identical. I'm thinking that that's what's happening to a lot of the branded items. They're getting killed by generic items put out by the huge retail chains. Proctor is way down from its highs, Gillette way down and could be a takeover, Nike was 76 at the high, now in the low 40s. Hasn't Warren Buffett predicated his investments on buying great monopoly-type brands like Coke. But now there are no more monopolies -- it's all price, price, price. Say good-bye to brands, they're history.

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The race for New York's Senate seat already has more drama in it than the race for the Presidency. As to why Giuliani dropped out, *New York* magazine put forth this explanation: "The idea that a man can battle cancer and get a divorce and romance a sweetie and be the mayor of New York and run a Senate race doesn't have many takers."

In the meantime, Hillary's new opponent, Rick Lazio, is turning out to be a handsome bull dog. He's stressing the fact that he's a New Yorker through and through while Hillary is just an ambitious carpetbagger from out there somewhere. Snaps Lazio, "Name one thing she has ever done for New York."

* * *

Microsoft, down from 119 to the current high 60's, has been built to a large extent on stock options. All 34,000 of its full-time workers have received stock options in lieu of higher pay. That worked well when the stock was heading skyward, but with the stock cut almost in half, options have a lot less appeal.

Employees of MSFT still have profits on their options since the average price at which these options could be exercised is just above $17. Last month MSFT attempted to overcome its option problems by doubling the number of shares covered by option grants. MSFT also has been trying to cancel out the potential watering of its stock via option exercising by buying back loads of MSFT stock. The company in its annual report stated that if it had paid cash instead of doling out options its expenses would have been its a huge $1.1 billion higher. Accountants tend to bury the costs saved by options in the footnotes of their report.

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The "Indians' Revenge." This ad appeared in the mid-May issue of the *San Diego Union*. California's many Indian tribes have the "go ahead" to offer Vegas-type gambling, and they're moving fast to do just that. I understand that Donald Trump is partnering with the Palm Desert Indian tribe to build a casino. I've always wondered why California was willing to give Nevada all that money from gambling (much of it from California players.) My guess is that in time new plush California casinos will draw a lot of players from Las Vegas.

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* * *

Values: The widely-followed *Value Line* investment service currently offers a list entitled "stocks ranked 1 (highest) for performance." *Value Line* lists 100 stocks along with safety rank, beta and yield for each. I was interested to see that of the 100 stocks listed, only three pay a dividend. Of the three that do pay dividends, one boasts a dividend yield of .5%, one offers .4% and the third offers 2.0%.

* * *

Question: What do you do with a stock that is down, say 30%, from where you bought it and on top of that it pays no dividend?

Answer: You HOPE it goes up. In my experience, any time you find yourself hoping in this business, you're in trouble.

* * *

This is interesting. The amount of money that is now indexed to the Dow is around $35 billion. The amount of money indexed to the S&P 500 is about $1 trillion. And the amount of money indexed to the Wilshire 5000 is about $58 billion. Money follows performance. If the Dow outperforms the S&P a huge amount of money will siphon out of the S&P stocks and into the Dow stocks. Thus strength will follow strength, which is what happened earlier when the tech stocks surged, pushing up the S&P and leaving the "tech-hungry" Dow behind. This led to the Dow bringing in INTC and MSFT in order to level the playing field. At this point, the Dow can boast that it has MSFT, INTC, HWP and IBM, four tech stocks out of the 30 Dow stocks. The Dow is thus rendered more representative of the general US stock market and economy.

* * *

Values: I want to repeat the three criteria that the great Ben Graham presented for buying stocks that represent real value. These are criteria that were accepted for many years by some of the greatest value buyers in the business.

(1) The company should owe less than its worth, and

(2) The earnings yield should be twice the prevailing AAA bond yield, or

(3) The dividend yield should be no less than two-thirds of the AAA bond yield.

Russell Comment: Gad, #3 alone would eliminate probably 97% of all the stocks available today.

* * *

This from a letter just received from a subscriber. "By the way, just like the gold prospectors who never made as much money as the store owners who sold them their tools and food, as a landlord of four commercial buildings in downtown San Francisco (where all the Internet companies want to locate), I have enjoyed huge rent increases from renting to dot-coms. My personal cash flow has gone from $20,000 a month to $50,000 a month! But I am keeping my lifestyle low, because I know that in a year to two I may have vacant space where the dot-coms are now (we get eight months prepaid rent plus one-year's rent on deposit, so I will get at least 20 months of rent)." **Russell Comment:** And that's the story in San Francisco. Who needs the gold rush of 1849?

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Last Friday our government came out with the latest Producer Price Index figures. Surprise, the PPI was unchanged with the so-called core rate up two-tenths. But does anyone believe these ridiculous government figures -- particularly as we near election time? Let me put it this way -- Gore needs a prosperous US economy to have any chance of winning. The nearer we get to the election, the less I trust any government economic statistics.

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Teeth: I've tried most of the tooth brushes on the market. Up to now, I've thought the Sonicare was the best. Then my dental hygienist told me about the Braun Oral-B 3D toothbrush, which she said was the best, particularly for getting rid of plaque. I bought an Oral-B 3D last week. After two brushings, I was sold. It's a great electric tooth brush. It gets the Russell seal of approval. Remember, God gives you only two sets of teeth. If you're reading this, you're on your second set, and there ain't no third.

* * *

Films: I've seen four good movies this year. The weird "Ghost Dog." The spectacular "Gladiator" (the first ten minutes is worth the price of admission). The off-beat "The Limey." And last week the noir, fascinating "The Croupier." Only one, Gladiator, is a typical Hollywood product, but don't let that stop you: Gladiator is well worth seeing for its spectacular fight battle scenes.

* * *

Amazon.com is supposed to be the leader of the e-tailers. But the AMZN story fascinates me. The financials of AMZN are striking. As of March 31, the balance sheet of AMZN showed $84 million of cash, which represented a decline of 30% in just three months. The company has sold five sets of junk bonds since it's been in business. AMZN has $2.1 billion now on its books but only $25.6 million of equity showing on its balance sheet. Each dollar of equity holds up 83 dollars of debt, one of the most leveraged positions of any US corporation. AMZN has run up some $1.2 billion in cumulative losses since its inception. It will be fascinating to see how or whether this company can survive. Note: recently CEO Jeff Bezos sold 380,000 shares of AMZN and has reportedly spent $7.5 million on a New York apartment on Central Park West. Nothing wrong with that and it was probably a good sale on the stock and maybe a bad buy on the apartment.

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Speaking of apartments, prices in NY and San Francisco have gone absolutely wild. In New York the trigger was Wall Street's prodigious profits and in San Francisco it's the dot.coms. The history of real estate in this nation is boom and bust, and it's obvious that we're still in the boom era. Buyers of huge expensive homes and apartments forget that taxes and carrying costs on these palaces can be huge. What happens when times get tough is that the owners often can't keep up the payments or that they get so worried about the illiquid and declining real estate market that they panic and dump their palaces for much, much lower prices.

Buyers forget that when the trend is down, real estate becomes extremely illiquid. Which is why fortunes are made in real estate at the bottom of bear markets. That's when prices are low and there's a real return on the investment.

A good test of real estate value is always the return on the investment. Example: figure it always costs at least 10% to carry a house (mortgage, taxes plus repairs). So if you buy a house for $750,000, figure it costs $75,000 per year to carry it. Test: can you rent the house and make a profit or at least break even? Odds are today that you can't rent that house for anything like $75,000 a year. Conclusion: If you buy a home today face it -- it may be wonderful but it's a huge luxury. Buying the same house for $350,000 in tough times is a different story. At that time, the same house might be a bargain. But today when you buy a house it's "pride of ownership," and that's OK, as long as you understand what you're doing. Of course, it is nice to have your own little home.

* * *

MOVING AVERAGES: I want to go over my method of reading the moving averages. I use two moving averages in my studies, a longer and a shorter MA. Let's take the 50-day and 200-day MAs. A stock is declining. If it continues to decline, at some point the shorter 50-day MA will drop below the longer 200-day MA. When that happens, I call it an important show of weakness.

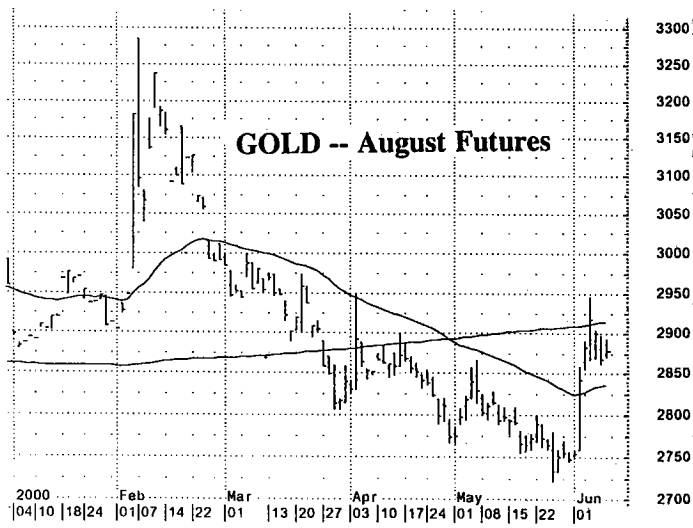
Then, at some point, the item will rally. If the rally is powerful and persistent, it will ultimately rally above the two MAs, and take the 50-day MA back above the 200-day MA. But if the rally is essentially weak, the 50-day MA will remain below the 200-day MA. In that case, I label it a weak or failing rally.

The item will then decline again. If the item breaks below its 50-day MA (which in turn has held below the 200-day MA), I call that a "sell signal."

Why is this a sell signal? It's a sell signal because the rally failed to take the 50-day above the 200-day, which was an indication of weakness. And when the item dropped back below the 50-day MA, that was a confirmation of the ongoing weakness and a "sell signal."

GOLD: OK, I'll hazard a guess. Gold made its low on May 25 on the August contract at 272.20. Since then August gold shot up to an intra-day high of 294.50 on June 6. August gold now seems to be consolidating in a technical "pennant" pattern.

August gold is now above its 50-day moving average, which stands at 284. And it's just below its 200-day MA, which stands at 292. What would be impressive action from here? Impressive action would have August gold rallying above 295. That's it. I'm being very tough, very difficult. Nothing about gold's action would impress me except a rally above 295 on August gold.



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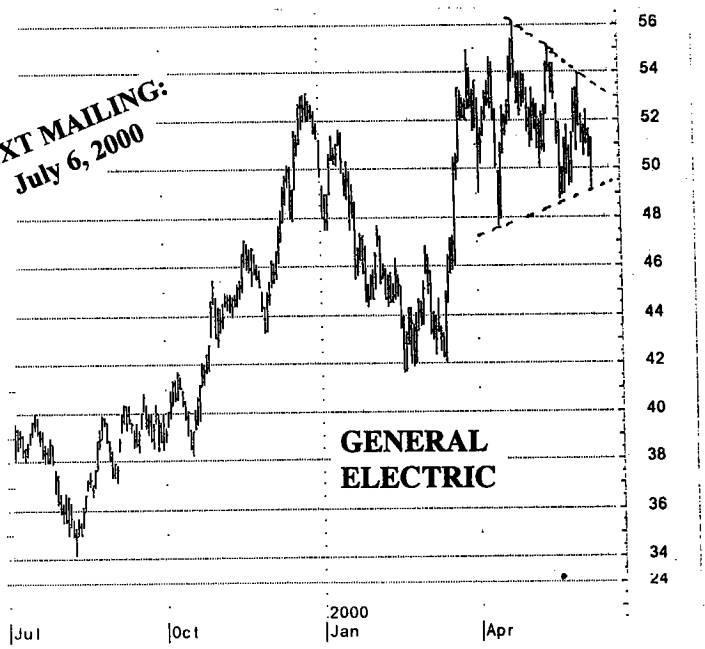

LATE NOTES: I show above a chart of GE. GE may be the most important single stock in the nation (it's so huge it literally is the US economy). GE has formed a huge symmetrical triangle with the apex of the triangle coming in below the level of the previous December peak of 53 -- not a bullish situation.

This is a rather strange formation to appear IF the market is to go higher. My guess is that this is a distribution formation. At 47 GE would be breaking out of the triangle on the down side. Also, the 144-day moving average for GE comes in at 48. GE is a stock to watch.

The process of **attrition** continues in this bear market with almost every major stock such as WMT, HD, MCD, MSFT, CSCO, INTC, YHOO, CMGI, AMZN, looking toppy or breaking down.